

15

Supreme Court, U.S.

FILED

OCT 11 1994

OFFICE OF THE CLERK

No. 93-404

In The
Supreme Court of the United States
October Term, 1994

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN
and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT
PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The
United States Court Of Appeals
For The Seventh Circuit

SUPPLEMENTAL BRIEF

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS

VEDDER, PRICE, KAUFMAN
& KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

*Counsel for Petitioner
Arthur L. Gustafson*

*Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI

SEYFARTH, SHAW, FAIRWEATHER
& GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

*Counsel for Petitioners
Daniel R. McLean and
Francis I. Butler*

*Counsel of Record

15 PP

TABLE OF CONTENTS

	Page
INTRODUCTION.....	1
ARGUMENT.....	1
A. The 1933 Act Regulates Initial Offerings and its Civil Remedies are Limited to that Context.....	1
B. Section 12(2) Does Not Apply to Negotiated Private Secondary Transactions or Ordinary Aftermarket Trading.....	6
C. Public Policy Precludes Application of Section 12(2) to Secondary Transactions.....	8
CONCLUSION	10

TABLE OF AUTHORITIES

Page

CASES

<i>Ackerberg v. Johnson</i> , 892 F.2d 1328 (CA8 1989)	7
<i>Ballay v. Legg Mason Wood Walker</i> , 925 F.2d 682 (CA3), <i>cert. denied</i> , 112 U.S. 79 (1991)	1, 6, 8, 9
<i>Central Bank of Denver v. First Interstate Bank of Denver</i> , 114 S.Ct. 1439 (1994)	1, 9
<i>Demarest v. Manspeaker</i> , 498 U.S. 184 (1991)	9
<i>First Union Discount Brokerage Services, Inc. v. Milos</i> , 997 F.2d 835 (CA11 1993)	1
<i>Pinter v. Dahl</i> , 486 U.S. 622 (1988)	8
<i>Ross v. Bank South, N.A.</i> , 885 F.2d 723 (CA11 1989)	9
<i>SEC v. Ralston Purina Co.</i> , 346 U.S. 119 (1953)	6
<i>United States v. Naftalin</i> , 441 U.S. 768 (1979)	5, 10
<i>United States v. Wolfson</i> , 405 F.2d 779 (CA2), <i>cert. denied</i> , 394 U.S. 946 (1969)	7

STATUTES AND REGULATIONS

British Companies Act, 19 and 20 Geo. 5, ch. 23 (1929)	3
§ 37	3
§ 380(1)	3
Securities Act of 1933, 15 U.S.C. 77a <i>et seq.</i>	<i>passim</i>
§ 2, 15 U.S.C. 77b	4
§ 2(1), 15 U.S.C. 77b(1)	6

TABLE OF AUTHORITIES - Continued

Page

§ 2(10), 15 U.S.C. 77b(10)	5
§ 2(11), 15 U.S.C. 77b(11)	7
§ 4, 15 U.S.C. 77d	7
§ 4(1), 15 U.S.C. 77d(1)	7
§ 4(2), 15 U.S.C. 77d(2)	7
§ 10, 15 U.S.C. 77j	4
§ 11, 15 U.S.C. 77k	5
§ 12, 15 U.S.C. 77l	5
§ 12(1), 15 U.S.C. 77l(1)	5
§ 12(2), 15 U.S.C. 77l(2)	<i>passim</i>
§ 17(a), 15 U.S.C. 77q(a)	5
Securities Exchange Act of 1934, 15 U.S.C. 78a <i>et seq.</i>	
§ 9, 15 U.S.C. 78i	8
§ 10, 15 U.S.C. 78j	8
§ 10(b), 15 U.S.C. 78j(b)	4

MISCELLANEOUS

H. Rep. No. 85, 73rd Cong., 1st Sess. 5 (1933)	<i>passim</i>
S. Rep. No. 47, 73rd Cong., 1st Sess. 5 (1933)	3
ABA Report, <i>The Section "4 (1 1/2)" Phenomenon: Private Resales of "Restricted" Securities</i> , 34 Bus. Law 1961 (1979)	7
Black, <i>A Law Dictionary</i> , 959 (2d Ed. 1910)	4

TABLE OF AUTHORITIES – Continued

	Page
<i>Black's Law Dictionary</i> , 1451 (3d Ed. 1933)	4
Higgs, <i>Palgrave's Dictionary of Political Economy</i> , 233 (1924)	4
J. Landis, <i>The Legislative History of the 1933 Securities Act</i> , 28 Geo. Wash. L. Rev. 29 (1959)	4, 6, 7
R. Prentice, <i>Section 12(2): A Remedy for Wrongs in the Secondary Market?</i> , 55 Alb. L. Rev. 97 (1991)	1, 5, 8
C. Schneider, <i>Section 4 (1 1/2) – Private Resales of Restricted or Control Securities</i> , 49 Ohio St. L. J. 501 (1988)	7
H. Shulman, <i>Civil Liability and the Securities Act</i> , 43 Yale L.J. 227 (1933)	3, 4
E. Weiss, <i>The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings</i> , 48 Bus. Law. 1 (1992)	1

INTRODUCTION

The Court has requested supplemental briefs as to whether Section 12(2) of the Securities Act of 1933 (the “Act”) is applicable to secondary transactions as well as initial offerings. If so, the Section represents a broad departure from the otherwise limited scope of the Act. As demonstrated in prior briefs and below, consistent with the Act’s other provisions, Section 12(2) applies to initial offerings, not secondary transactions. *Ballay v. Legg Mason Wood Walker*, 925 F.2d 682 (CA3), *cert. denied*, 112 U.S. 79 (1991); *First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835 (CA11 1993). *See generally*, E. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992) (“Weiss”); R. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991) (“Prentice”). Most clearly, Section 12(2) does not apply to the particular type of secondary transaction at issue here, a negotiated private secondary sale to sophisticated investors. This is demonstrated by the Act’s almost exclusive focus on regulating initial offerings, the context and language of Section 12(2), the fiduciary relationship Section 12(2) creates, and sound public policy.

ARGUMENT

A. The 1933 Act Regulates Initial Offerings and its Civil Remedies are Limited to that Context

“The 1933 Act regulates initial distributions of securities and the 1934 Act for the most part regulates post-distribution trading.” *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1445 (1994). The drafters of the 1933 Act articulated its limited scope, stating “[t]he bill affects only new offerings of securities. . . . It does not affect the ordinary redistribution of securities”. H. Rep. No. 85, 73rd Cong., 1st Sess. 5 (1933) (the “House Report”).

The exemption sections, 3 and 4, exempt, among other transactions in securities, transactions by individuals; the execution by brokers of customer's orders in open market; transactions by a dealer in securities not connected by time or circumstance with distribution of a new offering; * * * * In view of these exemptions *and the restriction of the bill's application to new offerings*, the bill does not affect transactions beyond the need of public protection in order to prevent recurrences of demonstrated abuses.

Id. at 6-7 (emphasis supplied).

As to the offerings it does regulate, the Act requires full disclosure of information by means of its registration requirements and adequate dissemination of such information by means of its prospectus delivery requirements. The civil remedies of the Act, consistent with this regulatory structure, apply only to misstatements "in the registration statement and the prospectus – the basic information by which the public is solicited." *Id.* at 9. They impose a duty which "varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect." *Id.* at 9. The constitutionality of the liability provisions was derived from the fact that, "[e]ven though the activities of particular persons concerned may be actually intrastate in character, they are, nevertheless, an integral part of a process calling for the interstate distribution of securities." *Id.* at 10. All these statements are patently inaccurate if Section 12(2) extends beyond initial distributions.

The Act's fiduciary based standards of disclosure and civil liability flow from the element of "trusteeship" applicable in the context of initial offerings. The President's letter recommending the legislation stated that those "handling or using other people's money are trustees acting for others." *Id.* at 2. The Act's civil liability provisions are a demand that persons "who sponsor the investment of other people's money should be held up to the high standards of trusteeship." *Id.* at 3. He should suffer the loss "who occupies a position of trust

in the issuing corporation toward the stockholders." S. Rep. No. 47, 73rd Cong., 1st Sess. 5 (1933).

Unique civil remedies applicable to initial offerings were necessary because the common law was not "consciously and especially molded for the flotation of securities." H. Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933) ("Shulman"). Only in the context of initial offerings are the provisions of Section 12 of the Act appropriate:

- Section 12(2) only provides remedies to buyers which makes sense in the context of regulating initial offerings but not in secondary transactions where misrepresentations can also be made by a buyer;
- A negligence standard of fault is reasonable only as to those seeking to become "trustees" of "other people's money";¹
- The lack of any reliance requirement is reasonable only in the context of initial distributions where misstatements "because of their wide dissemination, determine the market price of the security". House Report at 10;
- Sellers in initial distributions should be liable because they are the investors' primary source of information about the security unlike many secondary transactions where other information regarding the value of the stock exists;

¹ The drafters explained that "[t]he committee is fortified in these [liability] sections by similar safeguards in the English Companies Act of 1929." House Report at 9. If Section 12(2) applied to secondary transactions as well as initial offerings, this statement was inaccurate because The British Companies Act imposed prospectus liability only in the context of solicitation of the public, defining prospectus as "any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company." 19 and 20 Geo. 5, ch. 23 § 37, § 308(1) (1929). That a similar meaning of prospectus was intended for purposes of imposition of Section 12(2) liability is the only reasonable inference from the characterization of the liability provisions in the Act as "similar".

- Allowing rescissionary damages as an alternative to rescission is reasonable in public offering contexts because a market exists for the security;² and
- If Section 12(2) were to apply to secondary market trading, its lack of scienter and reliance requirements would effectively eliminate the use of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") by securities purchasers.

As to the "exact scope" the drafters wanted the Securities Act to cover, "'Public offerings' as distinguished from 'private offerings' proved to be the answer." J. Landis, *The Legislative History of the 1933 Securities Act*, 28 Geo. Wash. L. Rev. 29, 37 (1959) ("Landis").

The language and context of Section 12(2) comport totally with the conclusion that it does not apply to secondary transactions. Referring to the *combined* import of the prospectus required by Section 10 and the definition of prospectus in Section 2, the House Report stated that "The full revelations required in the filed 'registration statement' should not be lost in the actual selling process." House Report at 10. It is for this reason that liability attaches under Section 12(2) only when securities are sold by means of a misleading prospectus, then defined as "a document . . . inviting the public to subscribe to the issue." Black, *A Law Dictionary*, 959 (2d Ed. 1910); accord, *Black's Law Dictionary* 1451 (3d Ed. 1933); Higgs, *Palgrave's Dictionary of Political Economy*, 233 (1924) ("the name for a notice calling the attention of the

² This expansion from the common law was justified because "All shares of an issue are alike. They are readily obtainable in the market. The price at any specific time is reasonably fixed." Shulman at 245. Thus, it makes little difference to a seller found liable under Section 12(2) whether the buyer returns the security or obtains rescissionary damages because the seller could replace the security he sold. *Id.* at 245-246. This justification does not apply, as in this case, where restoration of the status quo ante cannot be accomplished.

public to the issue of any stock").³ This commonly understood meaning is even more clearly applicable in light of Section 12(2)'s proximity to Sections 11 and 12(1) in the Act, which apply only in the context of the public distributions regulated by the Act.

It would be totally inconsistent with the foregoing to apply Section 12(2) broadly to embrace a negotiated private resale transaction or an ordinary trading transaction on an exchange. As observed by Prentice:

Given that the entire thrust of the '33 Act was to reform the distribution process, not secondary trading, congressional silence on the matter must be read as indicating that Section 12 should be construed consistently with that purpose. Section 11 is almost always limited to distributions, as is section 12(1). If Section 12(2) were intended to break out of this mold, one would expect some sort of express statement by Congress.

Prentice at 123.

Respondents erroneously contend that the combination of Sections 2(10) and 12(2) creates an all-encompassing remedy extending well beyond the otherwise limited focus of the Act, applying to *every* transaction, whether or not otherwise exempt from the Act, which involves *any* security. If they are correct, Congress should instead have written Section 12(2) to state "by means of any communication." That Congress knew how to create broader coverage is shown by the language it used in Section 17(a) of the Act which does apply to secondary transactions. *United States v. Naftalin*, 441 U.S. 768

³ This was also made clear by the statement that actions could not be brought under Sections 11 or 12 more than ten years "after the security was offered to the public." House Report at 24. This meaning is also compelled as to the definition of "prospectus" at Section 2(10) of the Act under the maxim *noscitur a sociis* since the words used there to define "prospectus" refer to the types of communications which commonly occurred in connection with public offerings, not private transactions or ordinary aftermarket trading. In any event, Section 2's introductory admonishment that its definitions apply "unless the context otherwise requires" obviously permits the more reasonable interpretation of the meaning of Section 12(2) urged by Petitioners.

(1979). That it did not use such broad language in Section 12(2) shows its intent to limit the transactions as to which that Section imposed liability. To conclude otherwise would improperly render the words used mere surplusage in violation of a cardinal rule of statutory construction. *Ballay*, 925 F.2d at 688-89.

Moreover, Section 2(1) of the Act defines "security" extremely broadly, including any note, evidence of indebtedness, investment contract, etc. Imposition of fiduciary based liability in the many contexts which may be embraced if the exemptions from the Act are superseded and the underlying primary purpose of the Act is ignored must require a compelling showing that such liability was intended, a showing which has not been, and cannot be, made by Respondents.

B. Section 12(2) Does Not Apply to Negotiated Private Secondary Transactions or Ordinary Aftermarket Trading

As discussed above, the Act's coverage was limited to public offerings. The clearest type of secondary transaction to which Section 12(2) does not apply is that involved here, the resale of long outstanding stock in a negotiated transaction to a sophisticated venture capital investor fully able to fend for itself.⁴ "The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government." Landis at 37. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Similarly not covered would be a private sale of 100 shares of stock and the many sales of small businesses such as restaurants, gas stations, barber shops, medical practices or whatever which occur daily. Unlike initial offerings

⁴ As some courts have recognized, there may be some secondary distributions which take on the characteristics of an initial public offering. *Ballay*, 925 F.2d at 690. Space does not permit full discussion of application of Section 12(2) to those transactions. However, there is no dispute that the transaction involved in this case does not have the characteristics of an initial public offering. See J. Williams opinion in this case at p. 12. Joint Appendix at 21.

and comparable transactions, these transactions are not regulated by the Act.⁵

The most ordinary type of secondary transaction occurs millions of times weekly, namely, ordinary aftermarket trading on exchanges. Such trading is exempt by Section 4 from registration under the Act (except when related to securities involved in offerings), see generally *United States v. Wolfson*, 405 F.2d 779 (CA2), cert. denied, 394 U.S. 946 (1969), but regulated extensively by the 1934 Act. To impose a fiduciary duty on one merely selling for customers for modest compensation is unreasonable. Furthermore, outside the offering context (in which the offeror is obligated to prepare a registration statement and deliver a prospectus upon which brokers or dealers may reasonably rely), brokers or dealers selling stock simply do not have access to the information necessary to satisfy the requirements of Section 12(2).⁶

As described fully in the Securities Industry Association's brief at 19-24, brokerage firms frequently distribute research applicable to various companies, the securities of which such firms may sell. Such research represents the best analysis possible given time constraints and without full information and serves a valuable role with regard to the efficient operation of capital markets. With the

⁵ Private transactions are exempted from the registration and prospectus delivery requirements of the Act whether they involve initial offerings or resales. As to issuers making *private* offerings the transaction is exempt by Section 4(2); *private* resales by non-controlling shareholders are exempted by Section 4(1); *private* resales by sellers who control the issuer are exempt under the "Section 4 1/2 exemption" which reflects the statutory relationship between Section 4(1) and 4(2) in light of the definition of underwriter in Section 2(11). See, *Ackerberg v. Johnson*, 892 F.2d 1328, 1335, n. 6 (CA8 1989); ABA Report, *The Section "4 (1 1/2)" Phenomenon: Private Resales of "Restricted" Securities*, 34 Bus. Law 1961 (1979); C. Schneider, *Section 4 (1 1/2) - Private Resales of Restricted or Control Securities*, 49 Ohio St. L. J. 501 (1988).

⁶ The Act applies to "registrations of offerings of securities under circumstances when the public interest might deem it wise to institute a system of controls - controls that have to be molded to the ability of the various types of sellers of securities to comply with their requirements. Issuers of securities, for example, can meet certain conditions that non-controlling holders who desire to market their holdings obviously cannot meet. This distinction, so important to any understanding of the scope of the Securities Act of 1933, had never therefore [sic] been recognized by the state blue sky laws." Landis at 32.

benefit of hindsight, after a security performs poorly, almost any report can be read as misstating or omitting a material fact. It would be totally unfair to impose a fiduciary duty on firms doing no more than selling shares and attempting to distribute useful research. More unreasonable would be such liability when the broker is deemed a seller when executing orders to sell pursuant to customer requests, receiving only a commission. *See, Pinter v. Dahl*, 486 U.S. 622 (1988).

That the 1933 Act did not regulate secondary transactions was confirmed by the criticisms of legislators who felt such regulation should have been included, the lack of any response that coverage was afforded by Section 12(2), the promise that regulation would be forthcoming in additional legislation, and the portions of the 1934 Act which in fact provided such regulation a year later. "[I]t took no powers of prognostication for Congress to conclude that the '33 Act should be limited to reforming distribution transactions. Formal introduction of bills to address [problems in the secondary market] was inevitable." Prentice at 118.⁷ The 1933 and 1934 Acts should be considered, as they were to a significant extent adopted, in harmony. "The negligence standard of sections 11 and 12 has proved the primary remedy in distributions, and the scienter standard of section 10(b) has provided the primary remedy for misconduct in the secondary market." *Id.* at 139; *see also, Ballay*, 925 F.2d at 692.

C. Public Policy Precludes Application of Section 12(2) to Secondary Transactions

The impact of making one side a fiduciary of the other in negotiated transactions would be "so bizarre" that even if Congress

⁷ The types of manipulative and deceptive transactions in "old stock" such as wash sales, pegging transactions, pooling arrangements, insider trading and the like which are explicitly proscribed by Sections 9 and 10 of the 1934 Act were, under the view of Section 12(2) presented by Respondents, already amply regulated by Section 12(2). A pooling group could not possibly induce purchases of stock if they disclosed the fact of pooling in advance. Similarly, one could not successfully engage in wash sales or pegging transactions if the material facts relating to such transactions were disclosed in advance. If Congress intended that Section 12(2) was to apply to all of these types of secondary transactions, then the specific prohibitions of the 1934 Act would be in large part redundant.

has used words appearing on their face to intend such a result, the Court would be warranted in concluding no such application was intended. *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991). Such bizarre results are shown here where, in the context of months of negotiation, extensive due diligence and a written agreement that included an express agreement that all prior oral representations were superseded, Buyers nonetheless attempt to isolate alleged oral representations as a basis for Section 12(2) liability. In any such transaction a buyer can nearly always – but perhaps solely for negotiating leverage – isolate a statement or omission upon which a claim of liability could be stated under the extraordinarily lenient standard of proof of Section 12(2). Indeed, it might be argued that such a private seller is not even permitted to bargain. If, in fact, a seller asks \$125,000 for a business really believed to be worth \$100,000, failure to disclose that fact arguably would constitute a material omission.

Nor is a fiduciary duty appropriate in ordinary after-market trading transactions on exchanges. As in *Ballay*, analysis by an employee and oral statements over a "squawk box" resulted at the trial level in liability exceeding \$1,000,000 to 41 plaintiffs suing a firm which received nothing more than commissions. Such liability is proper and permitted when the scienter required by the 1934 Act is involved, but is inappropriate under the simple negligence standard of Section 12.

As this Court explained in *Central Bank of Denver*, 114 S. Ct. at 1454, a broad and ambiguous standard of liability "exact[s] costs that may disserve the goals of fair dealing and efficiency in the securities markets" and is not a satisfactory rule as to the conduct of business transactions because of the significant potential for strike suits. These concerns are even more compelling with respect to Section 12(2) which requires no more fault than simple negligence, requires no reliance or causation and allows damages significantly greater than the measure ordinarily applied to deceptive statements. *See, Ross v. Bank South, N.A.*, 885 F.2d 723, 743 (CA11 1989).

CONCLUSION

Section 12(2) does not apply to secondary market transactions, including the privately negotiated contractual resale which occurred in this case.

Respondents and the SEC ask the Court to apply Section 12(2) far beyond the primary scope of the Act by incorporating a definition developed for purposes of the Act's registration requirements into Section 12(2) and ignoring the context and purpose of the Section. This Court in *United States v. Naftalin*, 441 U.S. 768 (1979), determined that a departure from the primary purpose of the Act requires an exceptional showing. There is no such showing that Section 12(2) was meant to depart broadly from the general scope of the Act.

Section 12(2) does not apply to privately negotiated secondary transactions or ordinary aftermarket transactions. This is connoted by Congress' use of the phrase "by means of a prospectus or oral communication" in Section 12(2) rather than the obvious and broader phrase "by means of any communication." Congress did not use such broader language because, consistent with the primary scope of the Act, Section 12(2) applies to sellers choosing to make initial offerings to the public. That is the commonly understood context in which a "prospectus" is prepared and distributed and the only context in which Section 12(2)'s fiduciary based remedy is fair and reasonable.

Respectfully submitted,

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS

VEDDER, PRICE, KAUFMAN
& KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

Counsel for Petitioner
Arthur L. Gustafson

*Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI

SEYFARTH, SHAW, FAIRWEATHER
& GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

Counsel for Petitioners
Daniel R. McLean and
Francis I. Butler

*Counsel of Record